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RR RUEHCHI RUEHCN RUEHDT RUEHHM
DE RUEHJA #3294/01 3370352
ZNR UUUUU ZZH
R 030352Z DEC 07
FM AMEMBASSY JAKARTA
TO RUEHC/SECSTATE WASHDC 7235
RUEATRS/DEPT OF TREASURY WASHDC
INFO RUEHJS/ASSOCIATION OF SOUTHEAST ASIAN NATIONS
RUCPDO/DEPT OF COMMERCE WASHDC
RUEHKO/AMEMBASSY TOKYO 1224
RUEHBJ/AMEMBASSY BEIJING 4544
RUEHBY/AMEMBASSY CANBERRA 1676
RUEHUL/AMEMBASSY SEOUL 4318
RUEAIIA/CIA WASHDC

UNCLAS SECTION 01 OF 02 JAKARTA 003294

SIPDIS

SENSITIVE
SIPDIS

DEPT FOR EAP/MTS, EAP/RSP AND EB/IFD/OMA
TREASURY FOR IA-BAUKOL, OTA-MCDONALD
SINGAPORE FOR TREASURY-BAKER
COMMERCE FOR 4430-BERLINGUETTE
DEPARTMENT PASS FEDERAL RESERVE SAN FRANCISCO FOR TCURRAN
DEPARTMENT PASS EXIM BANK

E.O. 12598: N/A

TAGS: [EFIN](#) [ECON](#) [EPET](#) [ENRG](#) [PGOV](#) [ID](#)

SUBJECT: INDONESIA - OIL PRICE CONCERNS

¶1. (SBU) Summary. Minister of Finance Sri Mulyani Indrawati restored some credibility to Indonesia's budget estimates on November 28 by incorporating higher global petroleum prices and continued declining domestic production into Government of Indonesia (GOI) analyses. Although she downplayed the budgetary impact, some economists remain concerned about the unrealistic expectations for production volume, international oil prices and continuing subsidies. Government of Indonesia (GOI) officials would like to avoid increases in retail prices before the 2009 elections, but may have to concede to subsidy cuts if smuggling renews. Even without subsidy cuts, the oil price will be another factor likely to push inflation beyond the central bank's target range. End summary.

Analysts Worry about Impact of Oil Price

¶2. (U) During a November 19-21 visit to Jakarta by Regional Financial Attache, analysts cited rising oil prices and falling production as the dominant risks to the health of the economy in ¶2008. Citi's Economic Analyst Anton Gunawan argued that declining oil production is a more important risk for 2008 than rising subsidies. Officially, the targeted oil output in the budget is 1.034 million barrels per day (bpd), which Gunawan feels is too high and not achievable. A drop in oil production will cause government revenue to fall and imports to rise, resulting in a wider fiscal deficit and trade deficit in refined oil products. As in 2005, high oil prices may lead to smuggling and fuel substitution which will further increase subsidies creating an even weaker overall fiscal position. Bank Indonesia's Wimboh Santoso voiced concerns that higher oil prices will push up production cost and hence product prices, feeding into inflation. A sensitivity analysis done by UBS showed that if oil prices were at \$95 per barrel in 2008, this could result in a 2.3% decline in GDP (after adjusting for other spending).

Minister Mulyani Reacts to Concerns on Production Side

¶3. (U) Finance Minister Sri Mulyani admitted on November 28 that the Ministry of Finance (MOF) has discarded the official production figure of 1.034 million bpd and is using 950,000 barrels a day in its scenario planning. Mulyani's official budget also uses \$60 per barrel as the average oil price, but she also provided analysis

using higher prices. Using the new production assumption, oil prices at \$100 per barrel and no change in retail prices, Mulyani estimated that the budget deficit in 2008 widens by a further Rp 54.7 trillion (see Table 1 for details). An analysis by Credit Suisse calculates that -- absent any offsetting changes -- this would increase the budget deficit from 1.7% of GDP to 3.0% of GDP, which is still manageable.

Table 1: Impact of Oil Prices
at \$100/Barrel in 2008

	Rp trillion
Additional revenue oil & gas (+)	124.0
Of which Distributed to regions (-)	17.6
Additional fuel subsidies (-)	131.0
Additional electricity subsidies (-)	27.8
Decline of revenue from non-oil & gas sector (-)	2.3
Additional deficit in 2008	54.7

Source: Ministry of Finance Office

14. (SBU) Citi analyst Anton Gunawan argued that the government may also have to increase retail prices to keep the costs of subsidies under control. International Monetary Fund (IMF) Resident Representative Armando Morales also voiced concerns that the conditions of 2005 -- where high subsidies led to widespread smuggling -- were returning. However in contrast, Dr. Anggito Abimanyu, Head of the Fiscal Policy Office said that the oil price assumption would be only formally reviewed again in June 2008 for

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budget purposes. "We are not closing the door on raising fuel prices, but prefer to increase the use of alternative energy sources." Indonesia is encouraging the use of LPG for cooking instead of heavily subsidized kerosene. Consumers have been reluctant to make the switch, however, due to the higher prices for LPG.

15. (SBU) As part of its Fast Track Electricity Building Program, announced in January 2006, state electricity company PLN plans to build 10,000 MW of coal-fired electricity plants by 2009. However, to date new coal-fired power plants account for less than two percent of installed capacity. The Fast Track program has been mired in delays, pushing back the completion date to 2010. Also, the GOI has attracted bidders for projects totaling 7700 MW only. A final problem: thermal coal has doubled in price in the last year, diminishing some of the budgetary savings. Despite these problems, economists and citizens alike continue to express reluctance to free up energy prices. BI's Santoso was also wary of price increases, noting that the 2005 increase led to "big suffering."

Oil's Impact on Inflation:
Higher Food Prices

16. (U) Both BI's Santoso and Citi's Gunawan agree that the impact of higher oil prices is not expected to be pass-through to consumer immediately. Retail consumptions remains subsidized, although the roughly 40% of oil products used by industry adjust to market conditions automatically. Absent an increase in retail prices, the impact on inflation, therefore, is felt only after a lag as producers try to absorb the increase cost of oil initially. One main transmission mechanism oil high oil prices to inflation is through the higher cost of food, which has already been under pressure due to infrastructure bottlenecks and bad weather. Adding in higher transport costs, further food inflation, and the higher costs of imports due to depreciation of the currency, it is not surprising that analysts expect that inflation in 2008 may come in at (or above) the upper limit of the BI target. The World Bank notes in a recent report that the persistent nature of these pressures has raised concerns that higher food prices may not be a

temporary, cyclical phenomenon.

Budget Credibility Restored - For Now

17. (SBU) Minister Mulyani's efforts to combat doubts about the budget credibility were admirable. However, if continued high oil prices lead to renewed smuggling, the GOI may be faced with pressure to increase retail prices to reduce subsidies. In such a scenario, BI will have to tighten monetary policy further to constrain inflation. Vice President Kalla (with whom Minister Mulyani does not always agree) has said publicly on several occasions in October and November that the GOI will not raise energy prices until after the 2009 elections.

HUME